# Weekly Economic Update—December 12th, 2022



The last policy-setting meeting of the year will be held this week, and only a rate hike that deviates from the consensus expectation of a half-percentage point would cause much of a ripple in the financial markets. Most attention will be focused on the updated Summary of Economic Projections, as the Fed has digested a lot of data since the last quarterly set of projections was made in September. Since then, the economy has turned out to be more resilient than expected and the Fed's primary concern, wage growth, has yet to show meaningful signs of slowing. Importantly, Fed officials have become even more adamant in their commitment to bring inflation to heel at whatever cost. There's a good chance the SEP will feature a higher peak federal funds rate in 2023 than the 4.6 percent median forecast made three months ago.

That said, Fed projections are moving targets, subject to change when the facts change. They are also influenced somewhat by the biases of Fed officials who are voting members on the FOMC. It's useful to note that this will be the last decision by the current makeup of the Committee, as the next policy-setting meeting on January 31-February 1 will feature a new cast of characters. Each year, four district bank presidents rotate in and out of the 12-member committee and the incoming group leans somewhat more dovish than the exiting crew. No doubt, the newcomers will base decisions on incoming data, and if the inflation trend yields upside surprises they will remain in the hawkish camp. On the margin, however, the likelihood of a pause or a dialing back of rate increases next year would be a bit greater amid sign of cooling inflationary pressures.

Indeed, several Fed officials have recently voiced support for a more wait-and-see approach to policy decisions, noting the lags with which rate hikes filter through to the economy. The financial markets are already pricing in rate cuts late next year, reflecting the perception that the Fed will go too far and induce a recession. Even Fed chair Powell has opined that the path to a "soft landing" has narrowed given the stubbornness of inflation that will require a more steadfast commitment on the part of the Fed to bring it under control. We are also less convinced that a soft landing can be achieved and expect a mild recession to unfold next year. Granted, that may seem at odds with the ongoing strength in the economy's main growth driver, consumers, who are keeping their wallets wide open and providing more momentum in the fourth quarter than expected.

But there's a big debate over how long they can sustain this behavior. On the plus side – and the one that makes the strongest case for a soft landing – is the continued strength of the job market. While job growth is slowing, there is still a large imbalance between the demand and supply of workers, underpinning the sturdy wage gains that should keep a solid floor under spending. According to the Atlanta Fed's wage tracker, wages are increasing at a 6.4 percent pace, which is inconsistent with the Fed 2 percent inflation target even under the most optimistic productivity assumption. Keep in mind that labor costs are the main driver of inflation in the services sector, where outsize price gains are more than offsetting sagging goods prices. Friday's report on producer prices in November highlighted that discrepancy, as the 0.4 percent increase in service prices far outpaced the 0.1 percent increase in goods prices.

If the job market stays strong, it provides a critical buffer against the Fed's rate hikes, making it more likely the economy can stay afloat and giving the inflation-fighting campaign more time to play out. But that's where the rubber meets the road, as sustained job growth depends on sustained demand growth, and the odds that consumers can buck the headwinds from higher interest rates and other emerging hurdles much longer are sinking. True, there is still a reservoir of purchasing power that has not been fully unleashed, as households collectively retain an abundance of pandemic-era savings. While a robust job market has no doubt kept consumers in a buying mood, the drawdown of these savings has greatly augmented the

**HEADQUARTERS:**
6650 SW Redwood Ln Suite 365
Portland OR 97224

spending boost from increased wages. In October, the savings rate fell to a near historic low of 2.3 percent, underpinning the surprising strength in personal consumption that month.

What's more, despite another decline in net worth during the third quarter – the third consecutive quarterly decline – households entered the period with a mountain of cash. The $392 billion wealth erosion primarily reflected sagging stock portfolios, but households kept their cash hoards mostly intact. As a percent of disposable incomes, holdings of liquid assets barely slipped from the all-time high set in the first quarter and remained well above the average level seen over the past sixty years. However, while the Federal Reserve has not yet released data on how these savings are distributed among income classes, previous readings strongly suggest that most of it is held by wealthier households who have a higher propensity to save than those lower down on the income ladder. Hence, these funds are less likely to enter the spending stream than would be the case if held by lower-income households.

Importantly, there are signs that consumer spending is increasingly supported by borrowing. Credit-card balances are climbing at a rapid clip, up 15 percent in October from a year ago, driving a $27 billion increase in consumer credit during the month. To be sure, debt burdens are still relatively light and historically low interest rates on loans made in recent years have put a lid on debt-servicing payments. But the main reason debt levels are still relatively low is because households used a big chunk of their stimulus checks early in the pandemic to pay off their obligations. Between March 2020 and January 2021, households paid down $128 billion of consumer loans. That was a time of course when consumers had few other options to put those funds to use, as lockdowns and supply shortages put the kibosh on spending. What was left over after paying down debt went into savings accounts, enabling lower income recipients of the stimulus payments to build up a formidable financial cushion.

But those tailwinds to spending are rapidly fading. Lower income households may still retain some excess savings, but most of it has been gobbled up by the surge in food, gas and heating prices. Most likely, the resurgence in credit card borrowing reflects growing pressure on household budgets that necessitates outside financing sources to support spending. Some relief may be forthcoming from the recent slide in gasoline prices, but it's unclear how long that trend will continue given the uncertainty of the Ukraine war and global conditions, including demand from China which has been sharply curtailed by Covid restrictions that are in the process of being lifted. The expiration of the expanded child tax credit this month – which paid families up to $3600 a year for each child – is another potential weight on lower-income household budgets if not renewed, something that is unlikely in a gridlocked Congress.

What's more, if consumers do need to step up borrowing to support spending, they will face another obstacle besides the shock of higher interest rates. Alongside the climb in credit-card debt – and a sign that it is being driven by lower-income households – is a rise in delinquency rates. The level is still low by historical standards, but it is climbing; the past-due balances in the third quarter matched the highest in more than two years, and a similar trend is underway for all consumer loans at banks. Not surprisingly, banks are turning more reluctant to extend credit to consumers. Forecasters looking for another recession signal can readily find one in the correlation between banks willingness to lend to consumers and the stage of the business cycle. As the chart shows, the reading is already firmly in recession territory.

To be sure, these downbeat signals point to weaker conditions going forward but give little indication as to how much of a restraint on activity they might bring about. Meanwhile, inflation, wages and consumer spending remain strong in the here and now, and that's what the Federal Reserve will be guided by at least at the next two policy meetings. We expect the Fed to follow through with market expectations of a half-percentage point increase in its policy rate next week and implement another hike at its January 31-February 1 meeting. By then, the new rotating members will have a seat on the committee and a slew of data depicting how the economy is performing around the turn of the year will be available. The question is, will the stage be set for the Fed to scale back the size of the rate hikes?

# FINANCIAL INDICATORS

| INTEREST RATES | Dec 9 | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| 3-month Treasury bill | 4.30 | 4.31 | 4.17 | 0.36 |
| 6-month Treasury bill | 4.73 | 4.67 | 4.54 | 0.70 |
| 3-month LIBOR | 4.73 | 4.77 | 4.65 | 0.39 |
| 2-year Treasury note | 4.36 | 4.29 | 4.32 | 1.52 |
| 5-year Treasury note | 3.77 | 3.66 | 3.95 | 1.87 |
| 10-year Treasury note | 3.58 | 3.49 | 3.82 | 1.94 |
| 30-year Treasury bond | 3.56 | 3.55 | 4.06 | 2.25 |
| | | | | |
| 30-year fixed mortgage rate | 6.33 | 6.49 | 7.08 | 3.69 |
| 15-year fixed mortgage rate | 5.67 | 5.76 | 6.38 | 2.93 |

| STOCK MARKET | | | | |
|---|---|---|---|---|
| Dow Jones Industrial Index | 3,476.46 | 34,429.88 | 33,747.86 | 34,738.06 |
| S&P 500 | 3,934.38 | 4,071.70 | 3,992.93 | 4,418.64 |
| NASDAQ | 11,004.62 | 11,461.50 | 11,323.33 | 13,791.15 |

| COMMODITIES | | | | |
|---|---|---|---|---|
| Gold ($ per troy ounce) | 1,809.40 | 1,811.40 | 1,774.20 | 1,860.60 |
| Oil ($ per barrel) - Crude Futures (WTI) | 71.58 | 80.34 | 88.86 | 93.90 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/ Quarter | Two-Months/ Quarters Ago | Average- Past Six Months or Quarters |
|---|---|---|---|---|
| ISM Services Index (November) | 56.5 | 54.4 | 56.7 | 56.1 |
| Consumer Credit (October) - $blns | 27.1 | 25.8 | 30.3 | 29.0 |
| U.S. Trade Deficit (October) - $blns | 33.5 | 33.3 | 32.7 | 33.5 |
| Producer Price index (November) - % change | 0.3 | 0.3 | 0.3 | 0.2 |

**HEADQUARTERS:**
6650 SW Redwood Ln Suite 365
Portland OR 97224